<u>IN THE SUPREME COURT OF THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA</u>

Attorney General,
Attorney General's Department,
Colombo 12.
<u>Plaintiff</u>

SC APPEAL NO: 170/2019
SC LA NO: SC/HCCA/LA/36/2018
HCCA: WP/HCCA/COL/112/2014(F)
DC COLOMBO: 02227/09/DMR

<u>Vs.</u>

Ceylinco General Insurance Ltd,
No. 69, Janadipathi Mawatha,
Colombo 01.
<u>Defendant</u>

<u>AND BETWEEN</u>

Attorney General,
Attorney General's Department,
Colombo 12.
<u>Plaintiff-Appellant</u>

<u>Vs.</u>

Ceylinco General Insurance Ltd,
No. 69, Janadipathi Mawatha,
Colombo 01.
<u>Defendant-Respondent</u>

AND NOW BETWEEN

Ceylinco General Insurance Ltd,
No. 69,
Janadipathi Mawatha,
Colombo 01.
Defendant-Respondent-Appellant

Vs.

Attorney General,
Attorney General's Department,
Colombo 12.
Plaintiff-Appellant-Respondent

Before: P. Padman Surasena, J.
Mahinda Samayawardhena, J.
Arjuna Obeyesekere, J.

Counsel: N.R. Sivendran with Sankamali Somaratna for the Defendant-Respondent-Appellant.
Sureka Ahmed, S.C., for the Petitioner-Appellant-Respondent.

Argued on : 11.02.2022

Written submissions:
by the Defendant-Respondent-Appellant on 11.02.2020
by the Plaintiff-Appellant-Respondent on 28.08.2020

Decided on: 17.11.2022

<u>Mahinda Samayawardhena, J.</u>

The plaintiff (the Attorney General on behalf of the State) filed this action against the defendant insurance company in the District Court of Colombo seeking to recover a sum of Rs. 818,061.20 with legal interest on the advance payment bond marked P1 read with P3, P6 and P7. The defendant filed answer seeking dismissal of the action. After trial, the District Court dismissed the plaintiff's action on the basis that the plaintiff had failed to make a valid demand during the validity period of the bond. On appeal, the High Court of Civil Appeal set aside the judgment and directed the District Court to enter judgment for the plaintiff on the basis that the demand on the advance payment bond was made during the validity period. Hence this appeal by the defendant. This court granted leave to appeal on the question whether the High Court of Civil Appeal erred in law in directing the District Court to enter judgment for the plaintiff when the demand on the advance payment bond was made after the lapse of the validity period of the bond.

Advance payment bonds, performance bonds, performance guarantees, bank guarantees, letters of guarantee, letters of credit etc. fall into one category and practically perform the same function. Performance bonds are common in construction contracts and real estate development. It guarantees due performance of the underlying contract between the employer and the contractor. Its purpose is to provide a prompt and readily realisable security for obligations undertaken in the underlying contract. That is the fundamental purpose of a performance bond. In all these transactions three parties can be identified: (a) the principal (obligor/debtor/contractor) at whose instance the instrument is issued; (b) the guarantor (surety/the financial institution, e.g. bank) who guarantees due performance of the obligations of the principal to the beneficiary; and (c) the beneficiary (obligee/creditor/employer) for whose

benefit the instrument is issued. In these instruments, the word bond and guarantee are used interchangeably. An advance performance bond is an instrument obtained from the guarantor by the principal for issuance to the beneficiary as a condition precedent to payment of an advance for works to be performed by the principal (since money is required for initial expenses such as labour, equipment, raw material). A performance bond is an instrument obtained from the guarantor by the principal for issuance to the beneficiary as a condition precedent to due execution of the overall contract. However in practical terms a performance bond covers both these aspects: advance payment and overall discharge of obligations. In all these instances, with the issuance of the bond, the guarantor guarantees to the beneficiary payment of the agreed amount without conditions, unless the bond is conditional, no sooner it is presented according to its terms to the guarantor for payment. Although a bond can be conditional or unconditional, the trend is that these bonds are issued at the instance of the principal to be payable to the beneficiary "on demand" without any conditions.

The following passage by Dr. Wickrema Weerasooriyia in *A Textbook of Commercial Law (Business law)* (4th edn) at page 647 shows that there is no clear difference between advance payment bonds and performance bonds.

> *The Third Party client wants an assurance that the contractor will perform the work satisfactorily and on time. The client has also to give the contractor what is called a "mobilization advance" so that the contractor can get together the required labour, equipment and raw material etc. In that context, the contractor gets its banker to issue the Performance Bond to the client. The Bond states that the contractor will perform as contracted and in the case of default, the Bank will pay the client. The Bank normally has money of the*

> *contractor in a bank account or fixed deposit to cover the amount of the bond.*

In *Banking Law and Practice* by R.K. Gupta (Volume 1, 2011 (reprint), Modern Law Publications) a performance guarantee is defined as follows:

> *The performance guarantees are issued by the banks on behalf of their clients in favour of third parties assuring that the customer on behalf of which guarantee is issued, will perform his obligations as per the terms and conditions of the contract, failing which the bank will compensate the third party by paying the amount specified in the guarantee. The performance guarantees are usually obtained where the contractor undertakes to complete the assignment within a specified period in accordance with the terms and conditions of the contract e.g. building and engineering contract.*

The International Chamber of Commerce Uniform Rules for Demand Guarantees (URDG 758) defines a demand guarantee or guarantee as "*any signed undertaking, however named or described, providing for payment on presentation of a complying demand.*"

In *Siporex Trade S.A. v. Banque Indosuez* [1986] 2 Lloyd's Law Reports 146, the purpose of a performance bond was descried as follows:

> *The whole commercial purpose of a performance bond was to provide a security which was to be readily, promptly and assuredly realisable when the prescribed event occurred; a purpose reflected in the provision that it should be payable on first demand; the bank guarantor was not and ought not to be concerned in any way with the rights and wrongs of the underlying transaction.*

Although there are three identifiable parties in these transactions as stated above, if the bond or guarantee is unconditional and payable on-

demand, it is trite law that transactions between the guarantor and the beneficiary under the performance bond are not tripartite transactions among the guarantor, the beneficiary and the principal, but simply autonomous or standalone transactions between the guarantor and the beneficiary despite reference being made to the underlying contract between the beneficiary and the principal. In other words, the guarantor shall not be entitled to refuse payment to the beneficiary due to issues between the guarantor and the principal or due to issues between the principal and the beneficiary. If the beneficiary makes the demand in accordance with the terms of the bond or guarantee, the guarantor has no option but to honour it. Any dispute between the principal and the beneficiary on the underlying contract shall be resolved in separate proceedings to which the guarantor will not be a party.

In *Tukan Timber LTD v. Barclays Bank PLC* [1987] 1 QB 171 at 174, Hirst J. observed:

> *It is of course very clearly established by the authorities that a letter of credit is autonomous, that the bank is not concerned in any way with the merits or demerits of the underlying transaction, and only in the most extremely exceptional circumstances should the Court interfere with the paying bank honouring a letter of credit in accordance with its terms bearing in mind the importance of the free and unrestricted flow of normal commercial dealings.*

In *Power Curber International Ltd. v. National Bank of Kuwait SAK* [1981] 3 All ER 607 at 614 Lord Denning M.R. observed "*Letters of credit have become established as a universally acceptable means of payment in international transactions. They are regarded by merchants the world over as equivalent to cash*".

In *R.D. Harbottle (Mercantile) Ltd v. National Westminster Bank Ltd* [1977] 2 All ER 862 at 870, Kerr J. remarked:

> *It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by banks. They are the life-blood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the banking chain. Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes under the contracts by litigation or arbitration as available to them or stipulated in the contracts.*

In *Sztejn v. J. Henry Schroder Banking Corporation* (1941) 31 N.Y.S. 2d 631 at 633 Shientag J. said:

> *It is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the efficiency of the letter of credit as an instrument for the financing of trade.*

Vide also *Edward Owen Engineering Ltd v. Barclays Bank International Ltd* [1978] 1 QB 159, *Pesticides India v. State Chemical and Pharmaceutical Corporation of India* (1983) 54 CompCas 147 Delhi, ILR 1981 Delhi 864.

Notwithstanding that these performance bonds are autonomous and standalone, if fraud is alleged and *prima facie* established, of which the guarantor has knowledge or notice, this general principle can be relaxed appropriately. In such event, the court can even issue an interim injunction preventing the bank from making payment on the instrument pending determination of the action. I must add that the mere sending of

a notice by the principal to the guarantor alleging fraud on the part of the beneficiary will not allow the guarantor to refuse payment; nor will the court clothe itself with jurisdiction on such bare assertions to stop payment on bonds or guarantees considered to be the lifeblood of international commerce or equivalent to cash. The court shall not make interim orders *ex parte* or inter *partes* unless a strong *prima facie* case has been made out on fraud. The fraud shall be of a serious character that goes to the root of the underlying contract; an alleged violation of a term of the contract such as delivery of substandard goods, an allegation of overpayments or underpayments are not sufficient enough to establish fraud. The court must guard itself against making this universally acceptable mode of payment in national and international trade ineffectual or nugatory by granting interim orders as a matter of course or as a matter of routine.

Examples for the applicability of such exception are rare. In *Edward Owen Engineering Ltd v. Barclays Bank International Ltd* (*supra*) at 169 Lord Denning M.R. stated "*the bank ought not to pay under the credit if it knows that the documents are forged or that the request for payment is made fraudulently in circumstances when there is no right to payment.*" At page 171 it was further observed:

> *All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without*

> *proof or conditions. The only exception is when there is a clear fraud of which the bank has notice.*

Ackner, L.J., in *United Trading Corporation S.A. and Murray Clayton Ltd v. Allied Arab Bank Ltd* [1985] 2 Lloyd's Law Reports 554 at 561 observed:

> *We would expect the Court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the Court considers that on the material before it the only realistic inference to draw is that of fraud, then the seller would have made out a sufficient case of fraud.*

In *Indica Traders (Pvt) Ltd v. Seoul Lanka Construction (Pvt) Ltd* [1994] 3 Sri LR 387 at 398, S.N. Silva J. (later C.J.) held:

> *It is thus clear that business transactions between a bank and a beneficiary, constituted in the nature of a performance bond, a performance guarantee, letter of guarantee or irrevocable letter of credit, whereby the bank is obliged to pay money to a beneficiary, are not tripartite transactions between the bank (surety), the beneficiary (creditor) and the party at whose instance the bond, guarantee or letter is issued (the principal debtor) but, simply transactions between the bank and the beneficiary. A bank thereby guarantees to the beneficiary payment of money and is obliged to honour that guarantee according to its terms. Any dispute that may arise between the beneficiary (creditor) and the party at whose instance the guarantee or letter is given (the principal debtor), on the underlying contract, cannot be urged to restrain the bank from*

honouring the guarantee or letter according to its terms. In an application for an injunction to restrain the bank from making payment, the Court has to consider whether there is a challenge to the validity of the bond, guarantee or letter itself, upon which payment is claimed and whether the conditions as specified in the writing are satisfied. If the challenge to the validity is not substantial and the conditions as specified in the writing are met, prima facie no injunction should be granted and the bank should be left free to honour its obligation.

The only exception to this general rule is where it is established by the party applying for the injunction that a claim for payment upon such bond, guarantee or letter is clearly fraudulent. A mere plea of fraud put in for the purpose of bringing the case within this exception and which rest on the uncorroborated statement of the applicant will not suffice. An injunction may be granted only in circumstances where the Court is satisfied that the bank should not effect payment. Therefore, an injunction may be granted on the ground of fraud only where there is clear evidence as to:

(i) the fact of fraud and,
(ii) the knowledge of the bank as to the facts constituting the fraud.

In relation to the standard of proof of fraud, it was further held at 399:

In any event, a default or a violation of a contract or even the receipt of an over payment does not constitute fraud. Fraud as contemplated in the exception stated above carries a far more serious connotation. It is such fraudulent conduct on the part of the beneficiary as would strike at the very root of the transaction and vitiate the bond, guarantee or letter.

In *Hemas Marketing (Pvt) Ltd v. Chandrasiri* [1994] 2 Sri LR 181 at 186-187, Ranaraja J. stated:

> *Bank guarantees like letters of credit and performance bonds are a "new creature" of the commercial world. per Lord Denning Edward Owen Engineering Ltd. v. Barclays Bank International Ltd (1978) All ER 976 at 981. They were established as a universally acceptable means of payment equivalent to cash in trade and commerce, on the basis that the promise of the issuing bank to pay was wholly independent of the contract between the buyer and the seller and the issuing bank would honour its obligations to pay regardless of the merits or demerits of the dispute between the buyer and the seller. (Power Curber International Ltd. v. National Bank of Kuwait [1981] 3 All ER 607) When a bank has given a guarantee, it is required to honour it according to its terms and is not concerned whether either party to the contract which underlay the contract was in default. (Edward Owen – (supra)). The whole purpose of such commercial instruments was to provide security which was to be readily, promptly and assuredly realisable when the prescribed event occurred. No bank is obliged to give such a guarantee unless they wished to and no doubt when they did so they properly exacted commercial terms and protected themselves by suitable cross indemnities. Siporex Trade SA v. Banque Indo Suez (1986) 2 Lloyd's Law List Reports 146. It is only in exceptional circumstances that courts will interfere with the machinery of obligations assumed by the banks. They are the lifeblood of international commerce. Such obligations are regarded as collateral to underlying rights and obligations between merchants at either end of the banking chain. Courts will leave the merchants to settle their disputes under the contracts by litigation. The courts are not concerned with the difficulties to enforce such claims. These are risks which merchants*

> *take. Harbottle (Mercantile) Ltd. v. National Westminster Bank Ltd. [1977] 2 All ER 862. If court interferes with a bank's undertaking it will undermine its greatest asset – its reputation for financial and contractual probity. Sir Donaldson MR - Boliventer Oil SA v. Chase Manhattan Bank [1984] 1 All ER 351 at 352. The only exception to that rule is where fraud by one of the parties to the underlying contract has been established and the bank had notice of the fraud. (Edward Owen - supra, Boliventer - supra). A mere plea of fraud put in for the purpose of bringing the case within this exception and which rests on the uncorroborated statements of the applicant will not suffice. An injunction may be granted only in circumstances when the court is satisfied that the bank should not effect payment. (S.N. Silva, J., Indika Traders v. Seoul Lanka Construction (Pvt) Ltd. CA 916/93).*

(*Vide* also *Pan Asia Bank Ltd v. Bentota MPCS Ltd and Another* [2012] 1 Sri LR 51)

In the instant case, the Commander of the Sri Lanka Army (the employer) entered into an agreement with M/s Nimali Builders (the contractor) for the latter to construct two storage ammunition dumps at the Ambepussa Army camp. The defendant (guarantor) issued P1 in favour of the Commander of the Sri Lanka Army guaranteeing payment of Rs. 809,880.00 from 03.10.2003 to 01.01.2004 "*in accordance with the said contract or in accordance with any subsequent agreement affecting the period of repayment*". The validity period was thereafter extended by P3 from 03.10.2003 to 10.10.2004 and the value of the bond was increased to Rs. 818,061.20.

It is common ground that in terms of paragraph 4 on page 2 of P1, there shall be a demand made during the validity period for the defendant to make the payment. The demand was made by the plaintiff by P7 dated

05.11.2004, which falls outside the extended validity period of P3, i.e. 10.10.2004.

The High Court of Civil Appeal set aside the judgment of the District Court and held with the plaintiff on the following basis:

(a) paragraph 3 of P1 provides for entering into "*any subsequent agreement affecting the period of repayment*";
(b) the plaintiff "*made a subsequent alteration affecting the period of repayment unilaterally*" and conveyed it to the defendant by P6 dated 05.10.2004, a date that falls within the validity period, "*but there was no objection to this alteration*" and "*tacit agreement of the [defendant] could therefore be inferred upon its failure to resist the alteration*" and hence "*it can safely be concluded that the [plaintiff] has made his claim during the validity period of the said advance payment bond*".

I am unable to accept this reasoning by any standard. What did the plaintiff convey to the defendant by P6? The plaintiff stated, "*The under mentioned bonds issued by you in respect of the above contract on behalf of M/s Nimali Builders, 292, Hospital Road, Kelanimulla, Angoda to be with held with immediate effect to keep our rights in accordance with the conditions of guarantee bonds*." Although the learned High Court Judge says that by this expression the plaintiff made an alteration affecting the period of repayment, which was tacitly accepted by the defendant in remaining silent, I cannot arrive at such a conclusion by reading the above. For me, this expression has no clear meaning to warrant a response. Learned State Counsel in this regard refers to issue No. 6 raised by the plaintiff and the answer of the learned District Judge given thereto which reads as follows:

එසේ ගිවිසුම අවසන් කිරීමට සිදුවීම හේතුවෙන් පැ1 අත්තිකාරම් බැඳුම්කරය මත වූ අයිතිය තහවුරු කර ගැනීම සඳහා එකී බැඳුම්කරය රඳවා තබාගන්නා බව විත්තිකරුට 2004.10.05 දිනැතිව දන්වා ඇත්තේද?

මුදල් රඳවා තැබීමට ඉල්ලා ඇත.

In accordance with this issue, the position of the plaintiff before the District Court was that by sending P6, the plaintiff informed the defendant that the plaintiff retains the bond in order to enforce the rights on the bond. The answer given to this issue is that the plaintiff has requested to retain the money. This itself explains that P6 is a document open to different interpretations. P6 is definitely neither a demand for payment on the bond nor a demand or request for further extension of the validity period of the bond beyond 10.10.2004 (the extended period agreed upon by P3).

The bond concerned was payable on demand. What is meant by a demand? A demand in this context means a clear request for payment of an amount due. The ICC Uniform Rules for Demand Guarantees (URDG 758) defines a demand as "*a signed document by the beneficiary demanding payment under a guarantee.*" A working definition for a valid demand was given in *Re Colonial Finance, Mortgage, Investment and Guarantee Corporation Ltd (1905) 6 SR (NSW) 1* cited in *Union Bank of Colombo Ltd v. Emm Chem (Pvt) Ltd and Others* (SC/APPEAL/CHC/22/11, SC Minutes of 07.03.2019):

> *there must be a clear intimation that payment is required to constitute a demand; nothing more is necessary, and the word 'demand' need not be used; neither is the validity of a demand lessened by its being clothed in the language of politeness. It must be of a peremptory character and unconditional, but the nature of the language is immaterial provided it has this effect.*

Contracts of guarantees are generally strictly construed. This happens in both ways: against the guarantor as well as in favour of the guarantor. It all depends on the terms of the guarantee. In *Blest v. Brown* (1862) 45 ER 1225 at 1229, Lord Campbell stated:

> *It must always be recollected in what manner a surety is bound. You bind him to the letter of his engagement. Beyond the proper interpretation of that engagement you have no hold upon him. He receives no benefit and no consideration. He is bound, therefore, merely according to the proper meaning and effect of the written engagement that he has entered into.*

There is no unilateral extension of time in P6, as the learned High Court Judge states, which could have been understood by the defendant to object to or accept tacitly or expressly. Even assuming the language in P6 is crystal clear, can the validity period of the bond be extended unilaterally by the plaintiff? The answer should be in the negative. For how long was an extension sought or agreed upon? There is no such indication in P6. An extension cannot be forever. It is uncontested that P1 provides for entering into "*any subsequent agreement affecting the period of repayment*" but P6 does not constitute a "*subsequent agreement affecting the period of repayment*".

The terms of a written contract cannot be implied in this manner. A high standard is required before a term will be implied into a contract. Imputing a term that the period of payment was extended for an indefinite period without the consent of the other party flouts commercial common sense. Terms are generally implied by necessary implication, by law or by custom. If the wording of a contract is capable of more than one meaning, it should be construed to further the parties' common intention and the essential purpose of the contract. Prof. C.G. Weeramantry in *The Law of Contracts*, vol II, page 572 states that terms are implied when

"*such implication is necessary in order to give to the contract the* *business efficacy which the parties intended*." However, he adds "*If the document will be effective without the term, no such implication will be made. An implied term cannot be added merely on the ground of reasonableness, but its existence must be a necessary implication from the circumstances of the case and the language of the contract.*"

An implied term can be discerned when it is obvious that such a term should be read into the contract. In *Reigate v. Union Manufacturing Co (Ramsbottom) Ltd* [1918] 1 KB 592 at 605 Scrutton L.J. observed:

> *The first thing is to see what the parties have expressed in the contract…A term can only be implied if it is necessary in the business sense to give efficacy to the contract, that is, if it is such a term that it can confidently be said that if at the time the contract was being negotiated someone had said to the parties, "What will happen in such a case?" they would both have replied: "Of course so and so will happen; we did not trouble to say that; it is too clear"*

Similar sentiments were echoed by MacKinnon L.J. in *Shirlaw v. Southern Foundries (1926) Ltd.* [1939] 2 KB 206 at 227:

> *Prima facie that which in any contract is left to be implied and need not be expressed is something so obvious that it goes without saying; so that, if, while the parties were making their bargain, an officious bystander were to suggest some express provision for it in their agreement, they would testily suppress him with a common, 'Oh, of course.'*

In *Pan Asia Bank Ltd. v. Bentota MPCS Ltd* [2012] 1 Sri LR 51, Basnayake J. observed:

> *The effect of a guarantee, like that of other contracts, depends on the words of the contract. In Smith Vs. Hughes (1871) LR 6 QB 597 at 607 Blackburn J said "If whatever a man's real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party and that other party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the party's terms". The question to be answered always is what is the meaning of what the parties have said? not what did the parties mean to say (Lord Simon of Glaisdae L Schuler AG Vs. Wickman Machine Tool Sales Ltd. [1973] All ER 39).*

Law of Guarantees by Geraldine Andrews and Richard Millett (6th edn, Sweet and Maxwell) at page 643 states "*the nature of performance guarantees is such that it is very difficult to persuade a court to imply terms into them."* The court cannot imply a term which is inconsistent with the express language of the bond agreed upon (*B.P. Refinery (Westernport) Pty Limited v. Shire of Hastings* (1977) 180 CLR 266, *Duke of Westminster v. Guild* [1985] QB 688). The bond in question expressly stipulates that a demand should be made before 10.10.2004 but no such demand was made.

I have no hesitation in holding that the High Court of Civil Appeal clearly erred when it held that the validity period of the advance payment bond was extended by P6 and therefore the demand made by P7 dated 05.11.2004 is within the extended validity period of the bond. There was no demand made during the validity period of the advance payment bond. I answer the question of law on which leave to appeal was granted in the affirmative, set aside the judgment of the High Court of Civil Appeal, restore the judgment of the District Court and allow the appeal with costs.

Judge of the Supreme Court

P. Padman Surasena, J.

I agree.

Judge of the Supreme Court

Arjuna Obeyesekere, J.

I agree.

Judge of the Supreme Court